

Message Text

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TO SECSTATE WASHDC IMMEDIATE 9962
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AMEMBASSY BRUSSELS
AMEMBASSY LONDON
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C O N F I D E N T I A L SECTION 1 OF 2 ROME 1017

USEEC AND USOECD ALSO FOR EMBASSIES

E.O. 11652: GDS
TAGS: EFIN, IT
SUBJECT: ECONOMIC IMPLICATIONS OF ITALY'S POLITICAL CRISIS

REF: (A) ROME 238, (B) ROME 456 (NOTAL)

1. THERE IS A STRONG TEMPTATION TO DRAW A PARALLEL BETWEEN
THE ECONOMIC IMPLICATIONS OF THE LATEST POLITICAL CRISIS
AND THE COURSE OF ECONOMIC EVENTS OF 1976, WHEN THE CALENDAR
YEAR ALSO OPENED WITH AN UNSTABLE POLITICAL SITUATION.
IF ONE IS TO BE GUIDED BY THE BEHAVIOR OF FINANCIAL
MARKETS, WHICH EVERYONE RECKONS TO BE GOOD BAROMETERS OF
MOODS IN THE FINANCIAL AND BUSINESS WORLDS, THEN THIS
TEMPTATION APPEARS TO BE MORE THAN JUST AN INTELLECTUAL
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CURIOSITY. ALTHOUGH, IN GENERAL, FINANCIAL MARKETS IN
ITALY LACK THE BREADTH AND DEPTH OF THOSE IN MORE
"SOPHISTICATED" ECONOMIES, THE FOREIGN EXCHANGE MARKET
IS A RELIABLE INDICATOR OF CONFIDENCE IN THE LIRA.
THE BEHAVIOR OF THIS MARKET CLEARLY SHOWED THAT THE
POLITICAL CRISIS WOULD HAVE ITS TOLL. AS THE RESIGNATION
OF THE ANDREOTTI GOVERNMENT APPROACHED, THE LIRA CAME

UNDER INCREASING PRESSURE AND THE BANK OF ITALY HAD TO INTERVENE TO PREVENT IT FROM FALLING TOO SHARPLY. TWO OTHER FACTORS ALSO CONTRIBUTED TO THE PRESENT WEAKENING OF THE LIRA: (A) THE ARREST IN THE SLIDE OF THE DOLLAR VIS-A-VIS OTHER EC CURRENCIES WHICH FOR THE LAST SEVERAL MONTHS HAD DISGUISED THE DOWNWARD DRIFT OF THE LIRA, AND (B) A RUMOR, STOUTLY DENIED BY SEVERAL GOVERNMENT OFFICIALS, THAT THE AUTHORITIES HAVE PREPARED A CONTINGENCY PLAN TO REIMPOSE EXCHANGE CONTROLS TO PREVENT A CURRENCY HEMORRHAGE AS OCCURRED IN 1976.

2. ECONOMIES DO NOT NORMALLY STOP AND GO IN RESPONSE TO POLITICAL EVENTS, ALTHOUGH THEY SOMETIMES CHANGE COURSE. IT IS, THEREFORE, ALWAYS DIFFICULT TO PREDICT THE EXACT ECONOMIC CONSEQUENCES OF A GIVEN POLITICAL CRISIS. IT IS PARTICULARLY SO IN ITALY BECAUSE POST-WAR GOVERNMENTS HAVE HAD SHORT LIFE-SPANS AND THE ITALIAN ECONOMY HAS "SURVIVED" THE RECURRING POLITICAL CRISES OF THE PAST. THEREFORE, INSTEAD OF TRYING TO PREDICT IN A QUANTITATIVE FASHION THE ECONOMIC IMPACT OF THE LATEST CRISIS, BELOW IS A LEDGER OF POSITIVE AND NEGATIVE FACTORS WHICH HAVE A DEFINITE BEARING ON ECONOMIC AND FINANCIAL PROSPECTS FOR 1978, FACTORS WHICH ARE SENSITIVE TO, AND AFFECTED BY, THE POLITICAL CLIMATE.

3. POSITIVE ASPECTS:
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-- LEVEL OF OFFICIAL RESERVES. ITALY CLOSED THE YEAR 1977 WITH ABOUT \$8.5 BILLION IN CONVERTIBLE FOREIGN EXCHANGE RESERVES. DURING THE PAST YEAR, THESE RESERVES WERE INCREASED BY \$5.5 BILLION. AT THE END OF 1975, TO RETURN TO THE PARALLEL WITH THE SITUATION AT THE BEGINNING OF 1976, OFFICIAL FOREIGN EXCHANGE RESERVES STOOD AT ONLY \$1.2 BILLION, DOWN FROM \$3.0 BILLION AT THE END OF 1974.

-- INTERNATIONAL COMPETITIVENESS. AT THE CURRENT EXCHANGE RATE, ITALY'S INTERNATIONAL COMPETITIVENESS IS SOMEWHAT STRONGER THAN IT WAS AT THE END OF 1975. (IN 1977, ITALY'S EXPORTS SEEMED TO HAVE INCREASED THEIR SHARE OF THE WORLD MARKET.) THIS IS NOT TO SAY, HOWEVER, THAT ITALY'S COMPETITIVENESS SHOULD NOT BE A CAUSE OF CONCERN. DURING THE COURSE OF LAST YEAR. ITALY LOST VIRTUALLY ALL THE COMPETITIVE GROUND IT HAD GAINED WITH THE DEPRECIATION OF THE LIRA DURING 1976. HENCE, TO THE EXTENT THAT DOMESTIC INFLATION EXCEEDS THE AVERAGE OF FOREIGN INFLATION DURING 1978, THE LIRA EXCHANGE RATE SHOULD BE ALLOWED TO COME DOWN. BUT THE CONTINUED

EXCESSIVE RISE IN UNIT LABOR COSTS REMAINS A DEBILITATING FORCE ON ITALY'S INTERNATIONAL COMPETITIVENESS WHICH CANNOT BE OFFSET BY EXCHANGE RATE ADJUSTMENTS, GIVEN THE INFLATIONARY FEEDBACK EFFECTS OF ITALY'S SYSTEM OF WAGE INDEXATION. (BEFORE THE ANDREOTTI GOVERNMENT RESIGNED, IT HAD REPORTEDLY PLANNED TO EXTEND THE FISCALIZATION OF SOCIAL BENEFITS BEYOND JANUARY 31 IN AN EFFORT TO CONTAIN THE RISE IN UNIT LABOR COSTS DURING 1978.)

-- INTERNATIONAL LIQUIDITY. MONETARY POLICY DURING THE PAST YEAR HAS BEEN PRUDENT AND THE CREATION OF INTERNAL LIQUIDITY HAS BEEN KEPT UNDER CONTROL. THE GROWTH OF MONEY SUPPLY (M2) THROUGH THE YEAR ENDING
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SEPTEMBER 1977 WAS ABOUT THE SAME AS IT HAD BEEN IN THE YEAR ENDING SEPTEMBER 1976 (ABOUT 20 PERCENT) AS COMPARED TO THE CONTINUOUS ACCELERATION IN THE GROWTH OF MONETARY AGGREGATES FROM MID-1975 THROUGH THE FIRST QUARTER OF 1976.

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C O N F I D E N T I A L SECTION 2 OF 2 ROME 1017

USEEC AND USOECD ALSO FOR EMBASSIES

-- INFLATION. THE RATE OF INFLATION WAS GRADUALLY REDUCED DURING THE COURSE OF 1977 WITH THE AVERAGE MONTHLY INCREASE IN PRICES DURING THE SECONF HALF ONLY 0.9 PERCENT, COMPARED TO THE FIRST HALF AVERAGE INCREASE OF 1. 4 PERCENT. THE CURRENT LEVEL (AVERAGE 18.1 PERCENT FOR 1977) IS STILL TOO HIGH AND THE ANDREOTTI GOVERNMENT HOPED TO REDUCE IT TO ABOUT 12 PERCENT DURING 1978.

4. NEGATIVE ASPECTS:

-- BUDGET DEFICIT. THE MOST IMMEDIATE PROBLEM FACING A NEW GOVERNMENT WILL BE THE NEED TO REDUCE THE LEVEL OF THE ENLRAGED PUBLIC SECTOR DEFICIT. IN FACT, THE DOWNFALL OF THE ANDREOTTI GOVERNMENT ORIGINATED, ON THE CONFIDENTIAL

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SURFACE AT LEAST, WITH DIFFERENCES OVER ECONOMIC POLICIES, INCLUDING OVER WAYS AND MEANS TO CONTROL THE ENLARGED DEFICIT. ACCORDING TO THE LATEST ESTIMATES, THE DEFICIT COLD REACH 29,000 TO 30,000 BILLION LIRE -- A 30 PERCENT INCREASE OVER 1977--IF NOTHING IS DONE TO REDUCE EXPENDITURES AND/OR RAISE REVENUES. THE LAST GOVERNMENT WAS HOPING TO REDUCE THE DEFICIT TO 24,000 BILLION LIRE, WHICH IT FELT WAS CONSISTENT WITH A FURTHER SCALING DOWN OF INFLATION AND A CURRENT ACCOUNT SURPLUS IN 1978. SHOULD ACTION BE DELAYED TOO MUCH LONGER ON THIS FRONT, THERE IS A REAL DANGER OF THE BUDGET DEFICIT BECOMING AN IRRESTIBLE INFLATIONARY FORCE. WHEN ITALY AND THE IMF FINALLY SIT DOWN TO REVIEW ITALY'S PERFORMANCE UNDER THE LETTER OF INTENT, THE LEVEL OF THE BUDGET DEFICIT WILL RECEIVE TOP BILLING.

-- FIRMS IN FINANCIAL DIFFICULTIES. A NUMBER OF FIRMS IN BOTH THE PUBLIC AND PRIVATE SECTORS ARE IN GRAVE FINANCIAL DIFFICULTIES BOTH BECAUSE OF CYCLICAL AND STRUCTURAL FACTORS (IN THE CHEMICAL, TEXTILE, STEEL AND FOOD PROCESSING SECTORS). IN ADDITION TO BEING A SERIOUS ECONOMIC PROBLEM, THIS HAS NOW BECOME A SOCIAL/ POLITICAL PROBLEM AS WELL. A NUMBER OF JOBS ARE IN JEOPARDY AND THE LABOR UNIONS WILL NOT LET THESE FIRMS GO UNDER. ONE OF THE LAST ACTS OF THE ANDREOTTI GOVERNMENT WAS TO APPROVE A 400 BILLION LIRE BAIL-OUT OPERATION TO GET THESE FIRMS THROUGH THE END OF JANUARY (SEE REF A). ADDITIONAL MEASURES WILL THUS BE REQUIRED

SOON.

-- UNEMPLOYMENT. APART FROM THE NEW STATISTICAL SERIES BEGUN IN 1977 WHICH MAKES COMPARISON WITH PREVIOUS YEARS' DATA IMPOSSIBLE, IT IS NEVERTHELESS CONFIDENTIAL

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APPARENT THAT UNEMPLOYMENT GREW IN 1977 AS INDUSTRIAL ACTIVITY DECLINED. IT IS EQUALLY APPARENT THAT PLANS FOR CONTINUED AUSTERITY WOULD NOT CREATE ENOUGH NEW JOBS TO ABSORB THE GROWTH IN LABOR FORCE, OR THOSE WHO MAY BE LAID OFF. THE NEW GOVERNMENT WILL THUS BE UNDER PRESSURE TO STIMULATE THE ECONOMY AND CREATE NEW JOBS. CONFINDUSTRIA HAS ALREADY PRESENTED ITS PRESCRIPTION CALLING FOR A 4.5 PERCENT GROWTH TARGET IN 1978.

-- DEBT SERVICE. DURING 1978 ITALY HAS TO REPAY ABOUT \$5.0 BILLION IN OFFICIAL DEBTS (SEE REF B). UNLESS THE MONETARY AUTHORITIES ARE PREPARED TO SEE OFFICIAL RESERVES DECLINE TO A DANGEROUSLY LOW LEVEL, SOME OF THESE DEBTS WILL NEED TO BE ROLLED OVER, OR NEW LOANS NEGOTIATED. THE EXTENT OF THE ROLL-OVER WILL DEPEND ON THE BEHAVIOR OF THE BALANCE OF PAYMENTS, WHICH IN TURN DEPENDS ON DOMESTIC ECONOMIC POLICIES. THE GREATER THE AMOUNT OF DOMESTIC REFLATION, THE HIGHER THE LEVEL OF ROLL-OVER REQUIRED.

-- SHORT-TERM BORROWING OVERHANG. COMMERCIAL BANKS HAVE A TOTAL NET FOREIGN DEBTOR POSITION OF ABOUT \$7.0 BILLION. A GOOD PORTION OF THE DEBT, PERHAPS AS MUCH AS HALF, COULD BE QUICKLY REVERSED IN ANY IMPENDING CRISIS OF CONFIDENCE. THIS REVERSAL WOULD IMPACT NEGATIVELY ON OFFICIAL RESERVE HOLDINGS. THE GAIN IN RESERVES OF LAST YEAR COULD, THEREFORE, TURN OUT TO HAVE BEEN EPHEMERAL SHOULD THERE BE A CONFIDENCE CRISIS.

5. TO SUM UP, THE ITALIAN ECONOMY ENTERED THE POLITICAL CRISIS AND 1978 FACING THE SAME STRUCTURAL PROBLEMS THAT HAVE BESEIGED IT FOR THE LAST SEVERAL YEARS. DURING ITS 18 MONTHS IN OFFICE, THE ANDREOTTI GOVERNMENT WAS SUCCESSFUL IN IMPLEMENTING A SHORT-TERM STABILIZATION PROGRAM, WHICH REDUCED INFLATION AND TURNED THE DEFICIT ON THE CURRENT ACCOUNT AROUND. AS CONFIDENTIAL

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A RESULT, ITALY REGAINED ITS CREDITWORTHINESS AND WAS

ABLE TO BORROW SIGNIFICANT AMOUNTS IN 1977. IN ORDER
TO MAINTAIN THAT CREDITWORTHINESS, HOWEVER, ITALY'S
POLITICAL LEADERS WILL HAVE TO RESOLVE THE CURRENT CRISIS
QUICKLY AND IN A WAY WHICH ASSURES FOREIGN CREDITORS
THAT THE SUCCESS OF THE LAST YEAR WILL NOT SOON BE
"WASTED."GARDNER

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